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C O N F I D E N T I A L SECTION 01 OF 03 SANAA 000843

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SUBJECT: LNG STEAMS AHEAD; INVESTORS WONDER IF YEMEN IS RELIABLE

REF: A. SANAA 2005 3185
¶B. SANAA 522

Classified By: Ambassador Thomas C. Krajeski for reason 1.4 (b) and (d)
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¶1. (C) SUMMARY: The biggest investment deal in Yemen's history is becoming reality. On March 6, Ambassador met Joel Fort, General Manager of the Yemen Liquid Natural Gas Company (YLNG) to discuss the status of the project. YLNG is currently finishing preparatory work for the pipeline and liquefaction plant that is expected to begin producing in ¶2009. The facility will ultimately bring Yemen an annual income of roughly USD 1 billion, with as much as 60 percent to be sold on the American market. A complicated legal dispute between the ROYG and Hunt Oil may still threaten the project, and corruption has created costly delays. Such obstacles come at the most inopportune moment, as YLNG's seeks to raise the USD 3.7 billion in financing on which the project depends. At this critical phase of the LNG project, it is imperative that Yemen help foster confidence among international investors. END SUMMARY.

A Monumental Project for Yemen and U.S.

¶2. (U) Planned since 1992, Yemen's LNG deal is finally getting underway. YLNG is an enormous project by Yemeni standards, requiring an initial investment of USD 3.7 billion before the first gas is sold. There are only 20 other plants like it in the world. Once operational, the sales are expected to provide the ROYG with approximately USD 1 billion annual revenues. There is an estimated USD 400 million American content in the investment phase. APCI has a USD 100 million contract to provide processors and equipment for the liquefied gas, General Electric is constructing four turbines (the main drivers for gas compression) in Greenville, South Carolina, and ELLIOTT has a USD 80 million contract to build compressors in Janet, Pennsylvania. In addition, KBR recently won a sub-contract for services with YLNG.

¶3. (U) YLNG is a partnership between Hunt (17 percent), Total (40 percent), SK Corp (10 percent), Hyundai (6 percent), and the state-owned Yemen Gas Company (23 percent). The gas has already been pre-sold in distribution deals that are expected to provide approximately 5.8 million tons per year for 20 years, primary to U.S. and Korean markets. The YLNG project is especially time sensitive, as buyers legally have the right to sue if the gas does not arrive on schedule. The Ministry of Oil (MOO) still insists that the first shipments will be delivered on schedule at the end of 2008, but most insiders now concede that the project will be delayed until early 2009.

¶4. (U) The project consists of a gas liquefaction plant, to be constructed at the Balhaf site, between Aden and Mukalla. The plant is fed by a pipeline from processing units in Marib, with the main section measuring 325 km. The gas itself originates in Block 18, operated until November 2005 by Hunt Oil. YLNG is currently completing the site preparation at Balhaf, and will soon begin construction of the pipeline and plant. On March 22, YLNG held an open forum in Sanaa to discuss the impact of the project on local communities, the environment, and Yemen's economy. YLNG has taken great pains to demonstrate that the Balhaf facility will be as ecologically friendly as possible, with little harm to coral reefs and fish stocks, and desalination plants to avoid draining the water table. The pipeline will largely be underground, and will be built on a route to avoid reservoirs and archaeological sites.

Hunt and ROYG: Enemies, A Love Story

¶5. (C) The main obstacle to the YLNG project will not be the environment, however, but the lingering legal conflict with Hunt Oil. On March 6, Ambassador met YLNG General Manager Joel Fort to discuss this and other issues. Hunt's dispute with the ROYG over an extension of its production sharing agreement for Block 18 is currently in arbitration in Paris, and according to Fort is unlikely to affect the LNG project directly. The larger issue revolves around a 1997 law in which the ROYG decreed that should Hunt depart as operator of Block 18, upstream gas rights would be transferred to the Marib Services Company (MSC). (Ref A) The law also stipulates that MSC has blocking rights on any new operator, as a means of safeguarding gas reserves for YLNG. Hunt hedged its bets

by buying 30 percent of MSC, and now contends (with support from Total) that the law was violated when the government-owned Safir Company took over operations from Hunt in November 2005. According to Fort, the ROYG's violation of its own laws is making banks nervous about investing in the project. Fort said the YLNG was engaged in extensive negotiations with the ROYG about the status of Block 18 gas, but the Ministry of Oil now seems to be avoiding the issue.

¶6. (C) For YLNG, there is an additional concern that Safir may not have the expertise necessary to maintain the integrity of the Block 18 facility. "Thankfully, the main gas reserve is hard to damage," said Fort. Nevertheless, the LNG pipeline must connect to a modified portion of the Block 18 installation, which could suffer if not properly maintained. YLNG recently sent a five-man audit team to inspect the facility, which found little decline in production but also little commitment to ongoing repairs. Without a change in operating procedures, said Fort, a major breakdown is likely within the next few months.

¶7. (C) Both the ROYG and LNG partners are trying to put the best spin possible on the Block 18 situation. On March 5, YLNG Deputy Project Manager Amin Al-Madhaji said: "The issue is between Hunt and the government, not Yemen LNG and the government." The Minister of Oil also tried to make this distinction in a meeting with Ambassador, but the issue refuses to die. Fort called the dispute over Block 18 "a potential killer of bankability," if outside investors deem Yemen too unstable for large-scale financing. Ambassador offered to raise this and other major issues with President Saleh, but Fort said he was not yet prepared to use such an "atomic bomb" approach, but did not rule it out for the future.

Corruption Creates Delays

¶8. (C) Fort blamed ROYG indecision and corruption for delays

to the project. Despite YLNG's exemption from local hiring laws and continuing efforts to employ large numbers of Yemenis, said Fort, there are constant pressures from ROYG officials to hire friends and relatives. The government also plays a very active role in tendering, where YLNG is expected to award contracts to local companies if they're within 15 percent of the next lowest bidder. Fort did not foresee much improvement under the new MOO, whom he regards as a "transitional minister." (Ref B) The main problem, explained Fort, was that the ROYG has no control over lower level officials looking to make a personal profit.

¶9. (C) Kevin Garder, Finance Manager for YLNG, also told Econoff that the Yemen Gas Company has yet to make a single payment required of it as a partner in YLNG. This is due to the fact that YGC has no operating capital, said Fort. The MOO has proposed solving this problem by providing investment from the General Corporation for Social Security. Abdulla Alwadee, Head of Human Resources Development at YLNG, told Econoff that he believed Fort's standards were too high. "When operating in this part of the world," said Alwadee, "you have to be prepared to make some compromises."

Financing Hinges on OPIC

¶10. (U) YLNG is hosting a financing meeting in Washington at the end of March, at which company representatives hope to attract the necessary U.S. and international investment to realize the project. The Overseas Private Investment Corporation (OPIC) is critical to these efforts and is considered by YLNG to be the bellwether investor. YLNG is hoping OPIC will provide approximately USD 300 million in loan guarantees to U.S. banks (Citibank is most often mentioned), after which other investors in France and South Korea are expected to follow suit.

¶11. (U) The first OPIC representative will arrive in Sanaa on April 6 to conduct an environmental assessment, with a broader financial mission expected at the end of the month. In conversations with Econoff, OPIC management was optimistic about prospects for the LNG deal, especially in light of the fact that the LNG has already been pre-sold to the U.S. and Korean buyers. Nevertheless, OPIC remains concerned about the status of Block 18, and expects clarity on the situation before the board makes its final decision (likely in May).

Failure is Not an Option

¶12. (C) COMMENT: Yemen quite simply cannot afford for LNG to fail. Facing a growing fiscal crisis, the ROYG is not in a position to risk losing USD 20 billion. Overall, progress on the project is encouraging, but as YLNG seeks out critical financing it must have the full support of the ROYG. Unlike smaller deals, in which the ROYG has the flexibility to play games and negotiate prices, there is little room for error with LNG. The project must be financed and completed on schedule, or it may never materialize. For OPIC and other investors to take the plunge, the ROYG must take immediate steps to resolve the dispute over Block 18, and verify that its Safir Company is managing the facility responsibly. If not, the ROYG needs to rectify the situation before investors make their decisions this spring. END COMMENT.
Krajeski